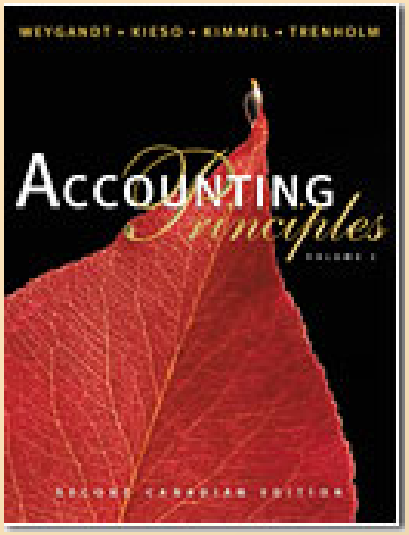


Accounting Principles

Second Canadian Edition

Weygandt · Kieso · Kimmel · Trenholm

WILEY

Prepared by:
Carole Bowman, Sheridan College

CHAPTER 15

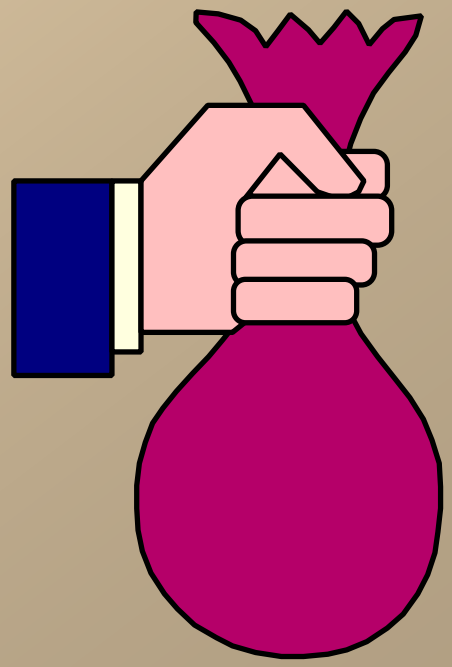
CORPORATIONS: DIVIDENDS, RETAINED EARNINGS, AND INCOME REPORTING

DIVIDENDS

- **A dividend is a distribution by a corporation to its shareholders on a pro rata (equal) basis.**
- **Dividends may be in the form of**
  - **Cash**
  - **Shares (normally common shares)**

CASH DIVIDENDS

- A cash dividend is a pro rata distribution of cash to shareholders.
- For a cash dividend to occur, a corporation must have:
  1. retained earnings,
  2. adequate cash, and
  3. declared dividends



ENTRIES FOR CASH DIVIDENDS

- **Three dates are important in connection with dividends:**
  - **Declaration date**
  - **Record date**
  - **Payment date**

ALLOCATING CASH DIVIDENDS BETWEEN PREFERRED AND COMMON SHARES

- **Cash dividends must first be paid to preferred shareholders *before* any common shareholders are paid.**
- **When preferred shares are *cumulative*, any dividends in arrears must be paid to preferred shareholders before allocating any dividends to common shareholders.**
- **When preferred shares are *non-cumulative*, only the current year's dividend must be paid to preferred shareholders before paying any dividends to common shareholders.**

STOCK DIVIDENDS

- **A stock dividend is a pro rata distribution of the corporation's own shares to its shareholders.**
- **A stock dividend results in a *decrease* in retained earnings and an *increase* in share capital since a portion of retained earnings is transferred to legal capital.**
- **In most cases, the fair market value is assigned to the dividend shares.**
- **Total shareholders' equity and the legal capital per share remain the same.**

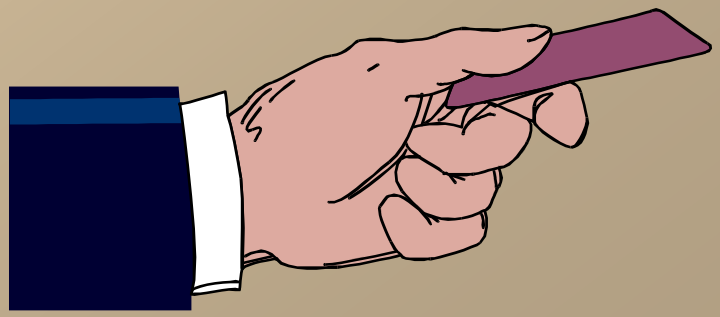


ILLUSTRATION 15-4
STOCK DIVIDEND EFFECTS

	Before Stock Dividend	After Stock Dividend
Shareholders' equity		
Common shares	$500,000	$575,000
Retained earnings	300,000	225,000
Total shareholders' equity	$800,000	$800,000
Issued shares	50,000	55,000
Book value per share	$ 16.00	$ 14.55

Stock dividends change the composition of shareholders' equity because a portion of retained earnings is *transferred* to contributed capital. However, *total* shareholders' equity remains the same. The number of shares increases and this means that the book value per share decreases.

PURPOSES AND BENEFITS OF STOCK DIVIDENDS

- **For company**
  - **To satisfy shareholders' dividend expectations without spending cash**
  - **To increase marketability of its shares by increasing number of shares and decreasing market price per share**
  - **To reinvest and restrict a portion of shareholders' equity**

PURPOSES AND BENEFITS OF STOCK DIVIDENDS

- **For shareholder**
  - **More shares with which to earn additional dividend income**
  - **More shares for future profitable resale, as share price climbs again**

STOCK SPLITS

- A stock split involves the issue of additional shares to shareholders according to their percentage of ownership.
- In a stock split, the *number* of shares is increased in the same proportion that legal capital per share is decreased.
- A stock split has *no effect* on total share (contributed) capital, retained earnings, or shareholders' equity.
- It is not necessary to formally journalize a stock split.

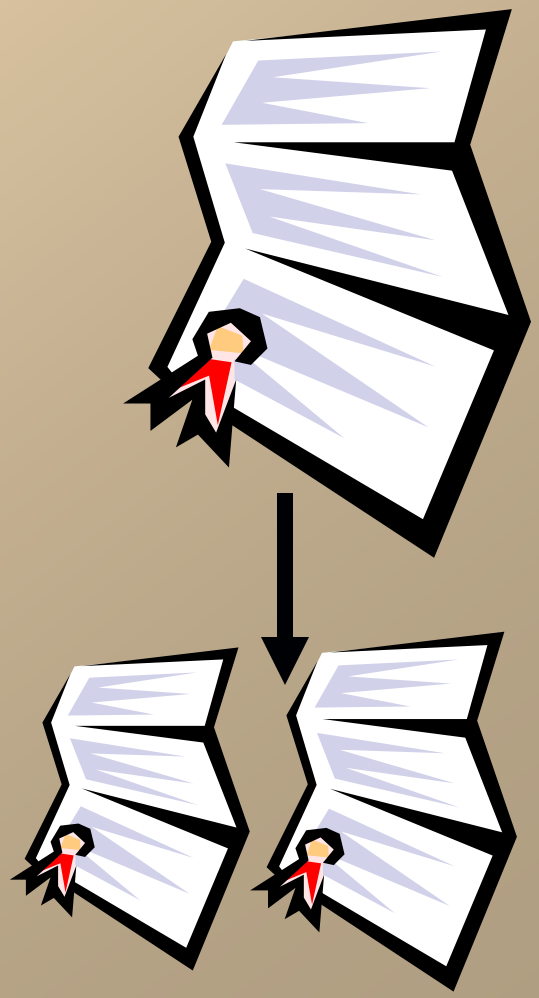


ILLUSTRATION 15-5
STOCK SPLIT EFFECTS

A stock split does not affect total share capital, retained earnings, or shareholders' equity. However, the number of shares increases and book value per share decreases.

	Before Stock Split	After Stock Split
Shareholders' equity		
Common shares	$500,000	$500,000
Retained earnings	300,000	300,000
Total shareholders' equity	$800,000	$800,000
Issued shares	50,000	100,000
Book value per share	$ 16.00	$ 8.00

ILLUSTRATION 15-6
EFFECTS OF STOCK SPLITS, STOCK DIVIDENDS, AND CASH DIVIDENDS

	Stock Split	Stock Dividend	Cash Dividend
Total assets	NE	NE	↓
Total liabilities	NE	NE	NE
Total shareholders' equity	NE	NE	↓
Total share capital	NE	↑	NE
Total retained earnings	NE	↓	↓
Legal capital per share	↓	NE	NE
Book value per share	↓	↓	↓
Number of shares	↑	↑	NE
% of shareholder ownership	NE	NE	NE

NE = No effect ↑ = Increase ↓ = Decrease

RETAINED EARNINGS

- **Retained earnings is the cumulative net earnings (less losses) that is retained in the business (i.e., not distributed to shareholders)**

Retained earnings, opening balance

+ Net earnings (or - net loss)

- Dividends

= Retained earnings, ending balance

DEFICIT

Shareholders' equity	
Share capital	
Common shares	**$800,000**
Retained earnings (deficit)	**(50,000)**
Total shareholders' equity	**$750,000**

A debit balance in retained earnings is identified as a DEFICIT and is reported as a deduction in the shareholders' equity section

RETAINED EARNINGS RESTRICTIONS

- **In some cases there may be retained earnings restrictions that make a portion of the balance currently *unavailable* for dividends**
- **Restrictions result from one or more of the following causes**
  - **Legal**
  - **Contractual**
  - **Voluntary**

PRIOR PERIOD ADJUSTMENTS

- **A prior period adjustment results from**
  1. **the correction of a *material* error in reporting net income in previously issued financial statements, or**
  2. **changing an accounting principle.**

PRIOR PERIOD ADJUSTMENTS

- **A correction of an error occurs after the books are closed, and relates to a prior accounting period.**
- **A change in an accounting principle occurs when the principle used in the current year is different from the one used in the preceding year.**

PRIOR PERIOD ADJUSTMENTS

- **The cumulative effect of the correction or change (net of income tax) should be**
  - **made directly to Retained Earnings;**
  - **reported in the current year's retained earnings statement as an adjustment of the beginning balance of Retained Earnings;**
  - **disclosed in a footnote to the financial statements;**
  - **corrected and restated in all prior period financial statements presented; and**
  - **the corrected amount or new principle should be used in reporting the results of operations of the current year.**

ILLUSTRATION 15-12
DEBITS AND CREDITS TO RETAINED EARNINGS

Retained Earnings	
Debits (Decreases)	**Credits (Increases)**
1. Correction of a prior period error that overstated income 2. Cumulative effect of a change in accounting principle that decreased income 3. Net loss 4. Cash dividends 5. Stock dividends	1. Correction of a prior period error that understated income 2. Cumulative effect of a change in accounting principle that increased income 3. Net income

Many corporations prepare a statement of retained earnings to explain the changes in retained earnings during the year. Some companies combine this statement of retained earnings with their income statement.

CORPORATION INCOME STATEMENTS

- **The income statement for a corporation includes essentially the same sections as in a proprietorship or a partnership.**
- **The major difference is a section for income tax expense.**
- **For tax purposes, corporations are considered to be a separate legal entity.**

ILLUSTRATION 15-15
INCOME STATEMENT WITH INCOME TAX

LEADS INC. Income Statement For the Year Ended December 31, 2003	
Sales	$800,000
Cost of goods sold	600,000
Gross profit	200,000
Operating expenses	50,000
Income from operations	150,000
Other revenues and gains	10,000
Other expenses and losses	4,000
Income before income tax	156,000
Income tax expense	46,800
Net Income	$109,200

INTRAPERIOD TAX ALLOCATION

- **Intraperiod tax allocation refers to the procedure of associating income taxes within the income statement to the specific item that directly affects the income taxes for the period.**
- **In contrast, interperiod tax allocation allocates income taxes between two or more periods.**
- **Under intraperiod tax allocation, the income tax expense or tax saving is shown for income before income tax.**
- **Each non-typical item discussed next is also shown net of tax.**

ADDITIONAL SECTIONS OF AN INCOME STATEMENT

- Additional sections should be added to the income statement to report material items not typical of regular operations.
- These non-typical times include:
    1. discontinued operations
    2. extraordinary items

- Each item should be carefully explained in notes to the financial statements, and the income statement should report the income tax expense or savings applicable to each item.

DISCONTINUED OPERATIONS

- **Discontinued operations refers to the disposal of a significant segment of a business, such as the elimination of an entire activity or of a major class of customers.**
- **Income statement reports both income (loss) from continuing operations and income (loss) from discontinued operations.**
- **Income (loss) from discontinued operations consists of 1) income (loss) from operations and 2) gain (loss) on disposal of the segment.**
- **Both components are reported net of applicable income tax in a section entitled Discontinued Operations, which follows Income from Continuing Operations.**

ILLUSTRATION 15-16
STATEMENT PRESENTATION OF DISCONTINUED OPERATIONS

HWA ENERGY INC.

Income before income tax		**$800,000**
Income tax expense		**240,000**
Income from continuing operations		**560,000**
Discontinued operations		
Loss from operations of chemical division, net of $60,000 income tax saving	$140,000	
Loss from disposal of chemical division, net of $30,000 income tax saving	70,000	210,000
Net income		$350,000

Note that the caption "Income from continuing operations" is used and that a section "Discontinued operations" is added. Within the new section, both the operating loss and the loss on disposal are reported net of applicable income tax.

EXTRAORDINARY ITEMS

- **Extraordinary items are events and transactions that meet three conditions:**
  - **Infrequent**
  - **Non-typical**
  - **Not subject to management decision**

- **Extraordinary items are reported net of income tax in a separate section of the income statement immediately following discontinued operations.**

EXAMPLES OF EXTRAORDINARY AND ORDINARY ITEMS

Extraordinary Items	Ordinary Items
1. Effects of major casualties (acts of God) if rare in the area 2. Expropriation (takeover) of property by a government 3. Effects of a newly enacted law or regulation, such as a condemnation action	1. Effects of major casualties (acts of God) if frequent in the area 2. Write down of inventories or write off of receivables 3. Losses attributable to labour disputes 4. Gains or losses from sale of capital assets

ILLUSTRATION 15-18
STATEMENT PRESENTATION OF EXTRAORDINARY ITEMS

HWA ENERGY INC. Income Statement (partial) For the Year Ended December 31, 2003		
Income before income tax		$800,000
Income tax expense		240,000
Income from continuing operations		560,000
Discontinued operations		
Loss from operations of chemical division, net of $60,000 income tax saving	$140,000	
Loss from disposal of chemical division, net of $30,000 income tax saving	70,000	210,000
Income before extraordinary item		350,000
Extraordinary item		
Expropriation of property, net of $21,000 income tax saving		49,000
Net income		$301,000

EARNINGS PER SHARE

- **Earnings per share (EPS) indicates the net income earned by each common share.**
- **Companies report earnings per share on the income statement**
- **The formula to calculate earnings per share when there has been no change in shares during the year is as follows:**

Net Income – Preferred Dividends ÷ **Number of Common Shares** = **Earnings per Share**

ILLUSTRATION 15-20
ADDITIONAL EARNINGS PER SHARE DISCLOSURES

HWA ENERGY, INC.

Net income	$301,000
Earnings per share	
Income from continuing operations	$5.60
Loss from discontinued operations	(2.10)
Income before extraordinary item	3.50
Extraordinary loss	(.49)
Net income	$3.01

When the income statement contains any non-typical item, EPS should be disclosed for each component.

PRICE - EARNINGS RATIO

The price-earnings (P/E) ratio helps investors determine whether the shares are a good investment in relation to earnings. It is a per share calculation, calculated by dividing the market price of the shares by its earnings per share.

A high P/E ratio can be one indicator that investors believe the company has future growth potential.

COPYRIGHT

WILEY